Bond Case Briefs

Municipal Finance Law Since 1971

Squire Patton Boggs: Tax-Exempt Stadium Financing? - There They Go Again.

Rep. Steve Russell, R-Okla., recently introduced a bill (H.R. 4838) in the House to prohibit tax-exempt financing of professional sports stadiums and for-profit entertainment facilities. This is only the most recent in a string of similar proposals, including by President Obama and former Senator Tom Coburn. In this case, tax-exempt financing would be prohibited for any "stadium or arena for professional sports exhibitions, games, or training" and for any "venue for any entertainment event (i) the live audience for which exceeds 100 individuals, and (ii) any net earnings from which inure to the benefit of an individual or any entity other than [the United States or any State or local governmental entity or certain tax-exempt organizations, including but not limited to 501(c)(3) organizations]," in each case if the facility is used for such purpose at least five days during any calendar year. (This post won't address the over-breadth of "entertainment facilities" included in this prohibition other than to note that, for example, many if not most public and private college arenas, theaters, etc. would be precluded from tax-exempt financing as a result of hosting performances, lectures, concerts, etc. provided by groups or individuals who are paid for their services.) The question considered in this post is not so much the propriety of permitting tax-advantaged financing of these sports and entertainment facilities but whether it is good policy to create targeted rules for certain facilities that may currently be out of favor rather than to rely on the fundamental principles of industrial development bond/private activity bond status that have limited the availability of tax-exempt financing for facilities with private involvement for almost 50 years.

Under current law, professional sports stadiums and arenas generally can be financed on a tax-exempt basis if the private security/payment limit is not exceeded. Some proposals to preclude these financings would impose a special rule to eliminate the private security/payment test for these facilities so that private business use by the teams alone is enough to prohibit tax-exempt financing. In contrast, Rep. Russell proposes an explicit prohibition against tax-exempt financing of professional sports and entertainment facilities. Both approaches reflect a fundamental departure from the private use and security/payment tests that have established the line between tax-exempt governmental financing and taxable governmental financing since 1968. As stated in Conference Report No. 1533, page 32, accompanying H.R. 15414, which first rendered interest on industrial development bonds taxable in 1968:

> On March 23 of this year the Internal Revenue Service published proposed regulations providing that the interest paid on industrial development bonds described in the proposed regulations would no longer be considered to be exempt under section 103. The proposed regulations represented a change in the position previously taken by the Internal Revenue Service and were based on the theory that industrial development bonds described in the proposed regulations were not "obligations of a State * * * or any political subdivision" within the meaning of section 103 since the primary obligor was not a State or political subdivision.

This underlying theory – that the governmental issuer was not the primary obligor of the bonds — explains why the private security/payment test has consistently been one of the two tests for the

fundamental distinction between governmental bonds and private activity bonds (formerly known as industrial development bonds). (Of course it has long been recognized that even where the proceeds of state or local bonds are loaned to a private person and the loan payments are the sole source of payment of the bonds, the state or local issuer of the bonds is respected as the issuer for federal income tax purposes. Nevertheless, the above theory explains the presence of the private security/payment test.)

The basic question of whether private activity bond status should rest on both a use test and a security/payment test was seriously reconsidered in 1985-'86 when bills preceding the Tax Reform Act of 1986 were progressing through Congress. The House bill, H.R. 3838, would have eliminated the private security/payment test, explained as follows:

> The committee is concerned . . . because under present law, a significant amount of bond proceeds from a governmental issue are being used in many cases by nongovernmental persons for activities which have not been approved specifically by Congress for tax exempt financing. . . . [G]overnmental bond issues are intentionally structured to fail the present-law IDB security interest test, when the bonds otherwise would be considered IDBs and subject to the restrictions that Congress has placed on such conduit financing for nongovernmental persons or would be prohibited altogether. The committee believes that this diversion of governmental bond proceeds to nongovernmental users should be limited . . . .
> H.R. Rep. No. 99-426, page 515.

The Senate Finance Committee recognized the same concern but addressed it differently, by subjecting both "direct and indirect" payments by a private user to the private security/payment test:

> The bill clarifies that both direct and indirect payments to an issuer of bonds made by a private user of bond-financed facilities are considered when determining whether the security interest test . . . is satisfied. Thus, payments by such private users of bond-financed facilities equal to or exceeding 25 percent [now 5%/10%] of debt service result in the bonds being IDBs, whether or not the payments are formally pledged as security or are directly used to pay debt service on the bonds.

Rep. No. 99-313, p. 831.

The Conference Committee generally adopted the Senate proposal, with an even more inclusive definition of private security/payments. The important point is that Congress carefully reconsidered the propriety of the private security/payment test and determined to retain it. (It is also worth noting that this Congress eliminated the previous ability, preserved in H.R. 15414 mentioned above, to use tax-exempt industrial development bonds to finance sports facilities. Thus Congress chose to eliminate the advantageous treatment of these facilities and to subject them to the same tests generally applicable to other facilities used by private business.)

So is the argument here that today's Congress is somehow bound by the actions of Congress 30 or 48 years ago? Of course not. The point is that this most fundamental concept in the tax-exempt bond rules – the definition of private activity bonds — has been carefully addressed twice during the existence of the tax-exempt bond rules and each time Congress has concluded that the private security/payment test, together with private business use test, are necessary. Maybe it did so in each case because of the resemblance of state or local bonds to private debt when a private person is effectively paying a significant portion of the debt service. Or maybe Congress didn't feel it should intrude on state or local governments that have decided to use their own tax or other revenues to

subsidize a private business activity. Likely, given the overlap in these concepts, it was a combination of the two.

In light of this history, if state or local governments can issue tax-exempt bonds to finance other subsidies to private business, why should the federal government single out sports and entertainment facilities for worse treatment? Stated otherwise, why should the federal government substitute its judgment for that of the local government by picking winners and losers. It might be argued that the cost of the subsidy to the federal government gives it the right to choose. While undoubtedly true as a legal matter, it must also be recognized that the local government is making the policy decision to subsidize the activity despite its cost in doing so (which is much greater than the cost to the federal government since it won't be receiving material payments from the private entities).

While professional sports facility financings have suffered much negative publicity in recent years, the fundamental question of whether these facilities are more or less worthy of local government subsidies relative to other private activities seeking local government subsidies is a question that is and should remain the decision of the local government. Furthermore, to the extent that the federal government has historically meddled in the affairs of local government, as described above, it has repeatedly determined that the private security/payment tests properly preserve the interests of the federal governments. The historic tests for tax-exempt status – the private business use test and the private security/payment test – should apply to sports and entertainment facilities, just as they apply to all other facilities used in private business.

Squire Patton Boggs

The Public Finance Tax Blog

Robert J. Eidnier

USA April 14 2016

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com